Flash Note
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The FED has fired the starting gun on its plan to start shrinking the US central bank's balance sheet. The implications.

On Fed rates:

- Policy makers maintained their outlook for one more hike in 2017.
- Policy makers also issued forecasts showing another three quarter-point rate increases in 2018.

On Fed's Balance Sheet: The FED has fired the starting gun on its plan to start shrinking the US central bank's balance sheet

- Outright contraction of Fed's balance sheet will start this year.
- Its balance sheet contraction will begin gradually by implementing the "don not reinvest caps", accelerate for a period of time, and then proceed at a constant rate until reaching a yet-to-be-determined "end" size:
  - ✓ For Treasury securities, the Fed set an initial cap of **$6 billion**. That will increase in steps of $6 billion each quarter over a year until it reaches **$30 billion a month**.
  - ✓ For mortgage-backed securities and federal agency debt, the Fed set an initial cap of **$4 billion**. That will increase in quarterly steps of $4 billion each quarter until it reaches **$20 billion a month**.

What sized balance sheet will the Fed be left with?

- ✓ The Fed did not specify how much it planned to shrink its balance sheet, but the bank did say its holdings won't return to prerecession level. Nevertheless we have some clues that allow us to estimate the intensity of the cut in the balance.
- ✓ Before 2008 the Fed kept tiny reserves compared to currency in circulation (this was because the Fed managed the short rates bay manipulating the level of scarce reserves available to banks).
- ✓ In 2008, the Fed shifted to direct management of rates paid (the so called "floor system"), that allowed short rates to be kept near zero despite financial stress.
- ✓ According to sources, the Fed may choose a level of reserves similar to the amount of currency in circulation (just as it did at the height of the crisis in Dec 2008).

- ✓ Curr. in circulation is now at US$1.5trn, if this is the desired level of Fx reserves, it follows that **shrinkage may only need to be about US$1.5trn** (Bernanke argued that the US economy could easily grow into that sum within 10 years, negating the need for balance sheet reduction).

Is there a US debt market crisis in the horizon?

- ✓ The FOMC has stated a desire to get out of the dirty MBS business and back toward a "clean" balance sheet, just comprised of US treasuries. This means that sales in UST are not going to be that aggressive.
- ✓ The minutes indicate it will start to phase out both reinvestments in MBS and treasuries. However, the Committee could yet accelerate its housecleaning in another way: While the Fed will start applying higher caps for MBS than Treasuries, whenever either cap is exceeded, the Fed will likely reinvest solely to treasuries.
- ✓ In this case, and knowing that the Fed's balance sheet reduction will fall below many of the forecasts, **any rise in long rates is likely to be modest**.
- ✓ In fact, I have the suspicion that the strong rally in the Treasury, seen yesterday, was precisely because it was leaked that the Fed's balance sheet will not return to past levels.

New Inflation projections could reduce the urgency policy makers feel to hike rates again in coming months.

- FOMC members recently dropped their median projection for inflation to 1.6 percent in 2017 from 1.9 percent forecast in March.
- The median forecasts for 2018 and 2019, however, were unchanged at 2 percent. (Japanese like experience?).
- Economic-growth projections were little changed, but the committee nudge up its full-year GDP forecast from 2.1 percent in March to 2.2 percent now.
- Fed Chair Janet Yellen is focused more on economic growth than she is inflation weakness (making us to think that the Fed will keep rising rates gradually).

Regards,

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